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PRESIDENT CLINTON'S FISCAL YEAR 1995 BUDGET PROPOSAL

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

FEBRUARY 8, 1994

Serial No. 103–17

Printed for the use of the Committee on the Budget

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PRESIDENT CLINTON'S FISCAL YEAR 1995 BUDGET PROPOSAL

TUESDAY, FEBRUARY 8, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 2 p.m., Room 210, Cannon House Office Building, Hon. Martin Olav Sabo, Chairman, presiding.

Members present: Representatives Sabo, Beilenson, Berman, Blackwell, Kasich, Snowe, Lazio, and Inglis.

Chairman SABO. Welcome to the Budget Committee, Dr. Tyson, and we are pleased to have you back with us. You certainly bring back better news this year than last year when we talked with you about the prospective economic plans for the country. All indications are that that plan is working, the economy is moving forward.

I also have to compliment you on the fact that the economic assumptions you made a year ago are accurate. I think in terms of a prediction by an administration, particularly by a new administration, they set records for being on target and accurate. There is very little variation.

Again, as we look to your projections for the future, we note that there is very little difference between you and CBO. We would all be pleased if you understate your assumption and reality turns out to be better. But this is a budget that is put together with conservative economic assumptions, and I think that is appropriate.

Clearly, the action we took last year has led to significant reduction in the deficit. As a matter of fact, all the current estimates are that the deficit will be substantially less than we thought when we passed the budget bill last August.

I am sure this committee will have lots of questions for you, and we look forward to your testimony.

[The prepared statement of Hon. Martin Olav Sabo follows:]

PREPARED STATEMENT OF HON. MARTIN OLAV SABO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Good afternoon. The House Budget Committee is in session for the purpose of a hearing with Laura D'Andrea Tyson, the Chair of the President's Council of Economic Advisers. We will be discussing the Administration's economic forecast as it relates to the budget and other economic issues that may have budget implications.

Welcome to the Budget Committee Dr. Tyson. In contrast to some other budgets in past years, I am pleased to note that your economic assumptions conform rather closely to those of the Congressional Budget Office and the private Blue Chip consensus.

You aren't making any extravagant claims for the economy here, but you are projecting steady economic growth, moderate inflation, a somewhat accelerated reduction on the unemployment rate, and continued lower long-term interest rates.

We—finally—seem to have a solid recovery setting in. I think the Administration and the Congress can claim a good share of the credit for the improvement in the economy and the deficits. Together, we delivered on our promise of substantial deficit reduction last year and are sticking to it. The lower interest rates that resulted have stimulated market confidence and economic activity.

Last Friday, however, the Federal Reserve, in a move to make sure inflation does not return, announced a small one quarter of a percentage point increase in the federal funds rate. The result was a widespread sell-off of stocks and bonds.

Your own assumptions have factored in the expectation of Federal Reserve actions to raise short-term interest rates year—and still you expect continued economic growth. Did the markets overreact? Is there a point a which a restrictive Federal Reserve policy could interfere with economic recovery?

At least one network evening news broadcast last Friday night saw that interest rate increase as one of two developments "unsettling" to the economy. The other development, it said, was an increase in unemployment. Yet, we know that the expected and long-forecast slight rise in the unemployment rate announced on Friday was only the result of a change in information-gathering procedures by the government, nothing more. The underlying unemployment rate is still down. And I believe you would agree that the economy is still on track, as well.

I look forward to your testimony.

Chairman SABO. Mr. Kasich?

Mr. KASICH. Thank you, Mr. Chairman.

Doctor, it is good to have you back again.

Now that it appears at least that the CBO has found about a $90 billion discrepancy in your health care projections. I do not think it is really accurate for it to be described as a conservative budget. I would like to point out, as I pointed out this morning, that these projections, particularly in the out years, are tentative at best. There are a number of circumstances which could make them inaccurate.

I have from the beginning questioned whether your projections for your health care reform plan were anywhere near the ball park. And it appears as though you were about $90 billion off. I am not sure that is going to end up being right. Nevertheless, what I am most concerned about is that we have some dramatic changes in the way the government functions, and I don't think we see it in this budget.

I really don't want to take a lot of time by making a statement now because we had an extended discussion this morning about this. But I would say, Doctor, that my concern is fundamentally that there is a window of opportunity to bring some real dramatic change to the way the Federal Government operates, and I think it is lacking in this proposal.

I welcome the 110 or 115 program cuts. I am going to help you as much as I can to make sure those get enacted. But those will save an outlay total of about $700 million, and $700 million compared to $1.5 trillion has to be kept in perspective.

But I will try to help you in that area. I am disappointed we are seeing entitlements grow. And of course the response from the administration is that our health care program will solve that. CBO came out with a study today which states your health care plan exacerbates the problems of entitlements.

But I do want to tell you that in those areas where you are trying to eliminate programs and even reduce some programs, if they are based on this Penny-Kasich bill, we are going to be out there trying to help you as much as we can. And I just want to say one final thing, and that is that your interest and my interest are the same. I guess it is a matter of how we get there. You want to have fast economic growth. I want to have fast economic growth.

I am glad we had quick economic growth in this last quarter. I hope it will continue. And if we reach a point where we begin to see we are not having the kind of growth we have to have, we will have to huddle and see if we can reach some agreement. Right now we are at a philosophical difference as to what we can do to guarantee long-term significant growth for our country.

I appreciate your being here today.

STATEMENT OF DR. LAURA D'ANDREA TYSON, CHAIR OF THE COUNCIL OF ECONOMIC ADVISERS

Dr. TYSON. Thank you very much, and thank you for the opportunity to discuss the budget and the economic assumptions upon which the fiscal year 1995 budget is based.

I want to begin by recalling where the economy was a year ago when we first proposed a multi-year deficit reduction program, of which the fiscal year 1995 budget is a part.

Last year at this time the economy confronted a complex set of short-term and long-term economic problems. The economy seemed to be caught in a largely jobless and see-saw or stop-go economic recovery that had considerable downside risk. The economy was in a recovery, but it was growing at less than one-half of the growth rate characteristic of a period of recovery.

Throughout 1992, the unemployment rate had remained above 7 percent, and at the end of 1992 there were still more than 9 million Americans out of work. So that was the short-term situation: a stop-go recovery with considerable downside risk.

This short-term problem was imposed on two long-term problems: the first was the problem of the growing Federal budget deficit, and the growing Federal debt.

Our projections at that time indicated that even if the pace of economic growth were to pick up, it would be choked off by growing structural deficits, ballooning borrowing needs of the government, and higher long-term interest rates that sooner or later would derail private spending.

In short, our economy was not on a sustainable path. The foundations upon which the economy was trying to recover were cracked, and they threatened to give way as the deficits began to grow in the out years.

That was the first long-term problem. The second long-term problem, which is a related problem to the deficit problem, was that over the long term our growth prospects looked relatively poor. We had been suffering from slow productivity growth for at least two decades. And the slow productivity growth could be easily traced to inadequate investment by the private sector in plant and equipment and inadequate investment by the public sector in education and training, research and development, and infrastructure.

This slow productivity growth resulting from inadequate investment, both publicly and privately, had led to very poor performance in family incomes, falling real wages for many Americans, disappointing growth in overall labor compensation, and the virtual stagnation of family incomes for average American families.

Of course, the situation was much worse for families at the bottom of the income distribution who saw their real family incomes, not just their wages, decline. For many working people at the bottom of the income distribution, their after-tax incomes barely exceeded income available to them through the welfare system.

So that is the situation we faced just a year ago. Where are we now, at the beginning of 1994, and what happened in 1993 to change things?

The beginning of 1994, all of the data that we can see on the economy confirm that the economy is now on a sustainable expansionary path, with increasing output, rising employment and a strengthening manufacturing sector.

The improvements in the economy have been driven or propelled by intra-sensitive components of spending—by business investment, by consumer spending on durables, and by residential construction—those parts of spending most sensitive to long-term interest rates.

These parts of spending have been stimulating and reinforcing growth in other parts of the economy. Consumer confidence has been picking up since the middle of 1993. Employment has increased by just about 2 million jobs over the past 12 months. And inflation remains tame.

If you look at 1993, the real growth rate in 1993 on an annual basis at 2.9 percent, that was the best performance in 5 years. And I might point out that was the performance that we predicted the economy would achieve last year.

We believe that the Clinton administration's deficit reduction plan, which was first announced to Congress in February of last year, and then was passed in August of last year, is a major factor behind the dramatic change in the economy's fortunes in the last year.

The key to the change in the economy's fortunes has been the dramatic decline in long-term interest rates which fell about 100 basis points between the November 1992 election and December 31, 1993.

The evidence indicates that in large measure the decline of long-term interest rates of this magnitude was the result of the response of the financial markets to the deficit reduction program. In the words of Alan Greenspan, the actions taken to reduce the deficit in 1993 were instrumental in creating the basis for declining inflationary expectations and easing pressures on long-term interest rates.

There is widespread agreement that the deficit reduction actions were a major reason that long-term interest rates took the course they took.

Now, the key to these long-term interest rate declines really was the credibility of the deficit reduction effort. And I want to emphasize this because it is very important to getting it right again in fiscal year 1995.

What we do has got to be credible. We cannot fool domestic and global financial markets. Credibility of our deficit reduction effort rests on four of its major features.

First of all, the caps on nominal spending. These are measurable, enforceable targets. The cap which shows us that in nominal terms discretionary spending is not going up and in real terms it is going down over a 5-year period, is very important to the credibility of the effort.

The specificity of the cuts that are proposed, and this year of course with the termination of 115 programs and cuts in 300 programs, these are very specific. There are no gimmicks here.

Our plan also involves a permanent increase in revenues. This is not a temporary increase of revenues that disappears at the end of the budget window. You can't fool financial markets with that.

And finally, the credibility of the plan is based on the credibility of the forecast. The economic assumptions for any budget will have an important impact on whether that budget is credible or not.

So our view is that in order to sustain what we have achieved, which is to get the economy on a stable expansionary path, we have to keep credible deficit reduction on track, and that is what the fiscal year 1995 budget proposal does.

We started again with a credible set of economic assumptions. Now, I can say, as someone who practices the art of forecasting, that it is a humbling experience, but there is one thing I think forecasters would agree upon, at least if they are interested in economic policy: It is easier to adjust economic policy in those situations when the economy outperforms your forecasts than it is to adjust economic policy when the economy underperforms your economic forecasts.

And with that in mind, I think we have always decided we would rather, if we have to err, we would rather err a little on the side of being overly cautious than on the side of being overly optimistic.

In any event, the forecasts I am about to discuss with you are very similar to those of the Congressional Budget Office. They are very similar to those of the Blue Chip forecasters. They are very similar to those of leading private forecasters out there in the economy. All these economic forecasts for 1994 and for the following years suggest moderate real growth in the overall economy, declining unemployment rates, low inflation, and fairly stable long-term interest rates.

Let me give you the details of the administration forecast for 1994 and a little bit beyond. These are shown in table 1 and are compared there with CBO economic assumptions. You could easily do a similar comparison with Blue Chip or other private forecasters.

As shown in table 1, the administration forecasts real economic growth of 3 percent in 1994, tapering off slightly to 2.7 percent in 1995 and 2.6 percent in 1988.

Inflation is measured by the Consumer Price Index. It is forecasted to be 3 percent in 1994, gradually increasing to 3.4 percent in 1998. During this window from 1994 to 1998, the civilian unemployment rate is forecast to average 6.3 in 1994 and to decline over time to an average of 5.5 in 1998.

I note in the testimony, but I won't go into detail here, that we are making forecasts based on the old measure of unemployment. That is really the only way to make forecasts right now. There is a new survey measure that is now being reported officially, and there is considerable uncertainty about the relationship between the old number and the new number. So what we do in our official forecasts at this point is forecast on the basis of the old survey number, and then include a range of what we think the new survey numbers will report.

I want to emphasize here that it is important to recognize that the difference between the old survey and the new survey is the difference in the way one measures unemployment. It does not suggest in any way that the actual problem of unemployment, or the extent of unemployment, has changed in the economy. It is simply that we are measuring it differently, and we believe we are measuring it better now. But it has not changed anything about the real economy.

Regarding interest rates, we forecast long-term interest rates will remain just about at the levels they were when we made the forecasts last month. Short-term interest rates, we have always predicted, from last year, actually, we began to predict that as the economy strengthened and entered a sustained expansionary period, there would be an increase in short-term interest rates, and indeed this is consistent with the announcement last Friday by the Federal Reserve that they will take actions to increase short-term interest rates. Our forecast calls for an average three-month Treasury bill rate of 3.4 percent for all of 1994, and right now we look to be on track for that.

Based on all of these economic assumptions, the fiscal year 1995 budget we have proposed keeps the economy on the course for a continuing dramatic improvement in the Federal deficit and the Federal debt. It keeps us on course for reversing the unsustainable and unhealthy trends that characterized our fiscal situation between 1980 and 1992.

The 1995 deficit is 40 percent below our initial projections. It falls to $176 billion. This will be the third consecutive year of a decline in the Federal deficit, which is the first time, of course, since Harry Truman was President.

Now, economists tend to measure the deficit and the debt not simply absolutely in terms of the amount, like $176 billion, but relative to the size of the economy. Relative to the size of the economy, the situation also looks like we are on the right course.

Between 1989 and 1992, the deficit compared to GDP or the deficit/GDP ratio increased from 2.9 percent to 4.9 percent. But now the deficit is on a declining course relative to GDP. It is slated to fall from 4.9 percent in 1992 to 2.5 percent in fiscal year 1995. That 2.5 percent will be the lowest figure hit since 1979.

I want to also emphasize that thereafter, even without health care reform and even without the debate that Mr. Kasich suggested we might enter, the deficit to GDP ratio in the budget window through 1999, as a result of OBRA 1993, the deficit to GDP ratio stabilizes at 2.3 percent.

So not only do we get down below where we were in 1980. We are back now to 1979. But then we stay there. There is no tendency in this budget window even without health care reform for the deficit to rise relative to the size of the economy. This is a major reversal of trend.

The second thing that economists look at is the debt relative to the gross domestic product or the debt relative to the size of the economy. In 1981, Federal debt held by the public was 26.5 percent of GDP. After 1981, over the next 12 years, this figure increased dramatically. It increased to 52.3 percent in 1994. So that is the debt to GDP ratio going from 26.5 percent in 1981 to 52.3 percent in 1994.

This trend under our budget proposal will be first stabilized and then reversed. We are now on a downward trend on the debt to GDP ratio. And that is absolutely essential to getting our fiscal situation under control.

Now, as far as the specifics of the budget itself are concerned, let me just give a few highlights, and then we can have a discussion. First of all, I want to emphasize that the budget was quite difficult to construct. This was the year the discretionary caps are really beginning to constrain the activities of various agencies.

Seven out of 14 of the major agencies have cuts in outlays or budget authority or both. Agency heads have come to realize that increasing spending in some area is going to require decreasing spending in other areas. This is absolutely necessary to achieve two goals at once: to bring discretionary spending down in real terms over a sustained period of time and at the same time to change what the government spends its money on.

Federal employment will also be reduced under the 1995 budget. President Clinton has issued an Executive Order which calls for 100,000 full-time equivalent employee reduction. Our budget plan for fiscal year 1995 exceeds that goal by 18 percent. And of course further reductions will be necessary in employment along with further reduction in spending in future years.

Now, while we hold discretionary spending constant in nominal terms and bring it down in real terms, we have to try to spend more in much-needed public investment areas. We believe—and I remember doing this last year before this committee—that public investment spending is an important complement to private investment spending to achieve long-term improvements in productivity growth and income growth.

In particular, the government does have a role to play in providing physical capital, human capital, and technological advances for the private sector. Those are the three major investment categories where our budget proposes an increase in spending.

On physical capital, we are requesting full funding for the core highway programs under ISTEA. We are requesting additional resources for Clean Water State revolving funds, and additional funds for high-performance computing and information highways.

Human capital, there are a number of initiatives here, including the National Service Initiative, increased funding for Head Start, the new school to work transition program and the new work force security initiative which Secretary Reich and the Department of Labor will be introducing this spring.

And finally, in the area of technological advance, we are asking for increased funding for the National Science Foundation, the National Institutes of Health, an expansion of the manufacturing extension programs, and a general reorientation of our large technological support budget away from defense needs and towards civilian needs.

I also want to point out that we will be coming forth in the spring with a welfare reform proposal. I do not discuss this in my testimony since we have not yet brought forth the package, but I do want to emphasize that we view this as a critical part of our budget priorities. We have already taken a step in this direction through the substantial increase in the earned income tax credit which was contained in OBRA 1993, helping 15 million American families bring their families out of poverty with full-time work.

A second step towards welfare reform will also come with health care reform, since many of the people on welfare are on welfare in order to achieve health care for their children and themselves.

The third step in welfare reform will be the welfare reform proposal that we introduce this spring.

And finally, of course, as we have noted again and again, if you look beyond the window, the budget window of 1999, you do see that the problems of the deficit in the longer term are linked inextricably to growth in health care spending, both Medicare and Medicaid. This point has been made by the CBO. It has been made by us. It has been made by private-sector analysts.

So ultimately we need to work together to achieve meaningful comprehensive health care reform, both to provide universal coverage for all Americans and also to bring our long-run deficit problem under control.

In conclusion, let me simply reiterate the main points of my testimony. Our economic forecasts make clear we believe the economy is on a sustainable expansion phase, accompanied by low inflation and significant job growth. We believe that the fiscal year 1995 budget proposal is one more step on the road to fiscal responsibility, and it also is an important step towards reorienting government spending to investments in our future.

This concludes my testimony, and I would like to have my full written testimony entered into the record.

[The prepared statement of Dr. Laura D'Andrea Tyson follows:]

Prepared Statement of Dr. Laura D'Andrea Tyson, Chair, Council of Economic Advisers

Mr. Chairman, before I get started, I want to thank you and the Committee for the opportunity to testify today.

Just about 1 year ago, President Clinton proposed a multi-faceted economic plan to reverse the growth of the Federal budget deficits and to redirect private and public sector spending toward productivity-enhancing investment.

With the support of Congress, the economic plan proposed last year became the basis for OBRA 1993, the largest deficit reduction plan in our Nation's history. This plan strengthened the Budget Enforcement Act and extended the discretionary spending caps through 1998. It proposed specific spending cuts in a wide variety of both discretionary and mandatory programs. Approximately one-half of the total estimated deficit reduction is attributable to savings on the spending side of the Federal budget. The remainder comes from additional revenues. Over 80 percent of the tax increases contained in OBRA 1993 are borne by those with annual incomes over $200,000. In fact, the income tax rate increases contained in OBRA 1993 apply only to the 1.2 percent of households with the highest incomes. For those workers at the bottom of the income scale, OBRA 1993 substantially increased the earned income tax credit (EITC). The result of these changes is a tax system that is more progressive than at any time since 1977.

The Situation in February 1993

Let us recall where the economy was last year, when the President's economic plan was proposed. The recovery had a stop and go feel to it. Throughout 1992, the unemployment rate remained above 7 percent. Too few jobs were being created, and there was great uncertainty about the pace of economic expansion.

Federal budget deficits were large and growing, apparently on an unsustainable path. Large amounts of Federal borrowing throughout the 1980s led to a legacy of debt, transforming the United States from a net lender to the largest debtor nation in the world. High levels of Federal borrowing led to real long-term interest rates that were very high by historical standards. These high interest rates discouraged businesses from making productivity-enhancing investments.

As the Administration took office, the economy's long-term prospects looked quite poor. Labor productivity growth had tailed off to an anemic 0.9 percent per year over the 1973-92 period. The Federal Government, by running large budget deficits, made it more difficult for the private sector to invest for future prosperity. Measures of the quality and quantity of public infrastructure suggested that the United States was also under-investing in public capital. Millions of Americans were functionally illiterate and, on international test scores, American school children suffered in comparison to their foreign counterparts in mathematics and science education. On top of this, a rising chorus of isolationist sentiment called for America to turn its back on international trade agreements intended to open up world markets for our goods and services.

The trends were worst for low-income families. The 1980s saw a dramatic widening in the inequality of earnings. From 1977-1990, the share of national income received by the 5 percent of the population with the highest incomes rose from 18.6 percent to 24.5 percent. In contrast, the share of national income received by the poorest 20 percent of the population fell from 5.7 percent to 4.3 percent. A widening of the wage distribution caused much of this increase in inequality. Wages for those at the top of the income distribution significantly rose in real terms, while wages for those at the bottom of the income distribution actually fell in real terms. Wages for those in the middle 60 percent of the income distribution were virtually stagnant. Workers with little education or job skills were falling further and further behind. Many low-income families with children justifiably felt that work did not pay since after-tax compensation from working often barely exceeded the potential benefits that could be claimed though the welfare system.

The Situation Today

In February 1994, the economy is poised for a sustained expansion. Real Gross Domestic Product (GDP) grew by 2.8 percent last year, with the second half of 1993 turning in a much stronger performance than the first half. In fact, the economic growth in the fourth quarter of 1993 was the strongest in 6 years. Long-term interest rates have declined by a full percentage point since Election Day in November 1992, and the interest-sensitive components of the economy have robustly responded to this decline. Overall, these interest-sensitive components of spending accounted for the lion's share of economic growth in 1993. Housing starts rose 25 percent from July to December 1993, producer durable investment increased by over 18 percent from the fourth quarter of 1992 to the fourth quarter of 1993, and consumers are purchasing more in the way of durable goods. Consumer confidence has been improving since the middle of 1993. All these are positive signs.

Inflation figures for 1993 indicate that price increases have moderated. The Consumer Price Index (CPI) increased a scant 2.7 percent in over 1993, the smallest increase since 1986. The core CPI (excluding the volatile food and energy components) was 3.2 percent, the smallest increase since 1972. And the implicit GDP price deflator increased at a rate of 2.2 percent, the smallest increase since the Johnson Administration.

The decline in long-term interest rates since January 1993 has tracked very closely the fortunes of the Administration's economic plan. This is evidence that the financial markets view the deficit reduction proposals as substantial and credible. The credibility of our deficit reduction plan rests on four general premises. First, discretionary spending is fixed in nominal terms, an objective test that is hard to evade by budget gimmickry. Second, specific spending cuts are proposed, showing that it is indeed possible to achieve the spending targets in the proposal. Some of these proposed spending cuts take on budgetary sacred cows, demonstrating the Clinton Administration's commitment to reduced spending, regardless of past treatment of programs. Third, the revenues raised generally are permanent and real. There is little in the revenue raising component of the President's economic plan that simply accelerates revenues into the budget window or that pairs temporary (e.g., 5 year) revenues with permanent spending programs. Fourth, the economic forecasts on which the economic plan is based are credible. All four premises are important in convincing the financial markets that the Federal Government will become a smaller player in the debt markets of the future. This realization helps reduce the long-term cost of borrowing for all market participants.

In terms that are important to most Americans—jobs—the economy enters 1994 in a much improved position from that at the start of 1993. During the past year, payroll employment increased at a rate of over 160,000 jobs per month, nearly 2 million jobs in all. This is ¼ of the way toward the Administration's goal of creating 8 million jobs in 4 years. After 1 year, private employment growth has exceeded the total for the entire tenure of the previous Administration. Moreover, the Council anticipates more than 2 million jobs being created in 1994, keeping the economy on track to meet the job creation goal.

It is true that most of the jobs created in 1993 are in the service sector. However, it does not follow that all of these are "bad jobs." For example, at the start of 1994, there are almost 200,000 more construction workers than at the beginning of 1993 and almost 400,000 more retail workers. Household surveys indicate 1 million more workers in managerial and professional specialty positions over the same period. And with the factory workweek and overtime at postwar record high levels, there is plenty of reason to expect that many of the jobs created in 1994 will be in the manufacturing sector.

The Administration's Economic Forecast

The Administration has been very concerned to keep its forecasts of key economic variables responsible and credible. Although practicing the art of forecasting economic performance is certainly a way to keep one humble, it is easier to adjust economic policy to situations in which the economy outperforms the forecasts than to situations in which the forecast outperforms the economy. And our forecasts are not unduly optimistic. Indeed, they are very similar to forecasts produced by the Congressional Budget Office, the Blue Chip consensus forecast, and leading private sector forecasters. All of these forecasts call for moderate real growth in the overall economy, declining unemployment rates, low inflation, and fairly stable long-term interest rates.

As shown in Table 1, the Administration forecasts real economic growth of 3.0 percent in 1994, tapering off slightly to 2.7 percent in 1995, and to 2.6 percent in 1998. Inflation, as measured by the Consumer Price Index, is forecast to be 3.0 percent in 1994, gradually increasing to 3.4 percent in 1998. The civilian unemployment rate is forecast to average 6.3 percent in 1994, dropping over time to an average of 5.5 percent in 1998.

There are two things to note about the forecasts of the unemployment rate. First, this measure uses the old definition of the unemployment rate, computed using a survey method used by the Census Bureau until 1994. The new measure of unemployment is expected to be somewhat higher than the old rate, probably 0.3-0.9 percentage points higher on average—the precise month-to-month discrepancy is impossible to know. We still forecast unemployment using the old definition because it makes comparisons with previous data easier and because models of the economy have not yet been adjusted to incorporate the new definition. A second thing to note is that the forecast of the unemployment rate presented here is somewhat lower than that contained in the Budget. This is because the Budget went to press using a forecast we made in early December. But the economy in the fourth quarter of 1993 exhibited stronger growth and a sharper drop in unemployment than expected. Incorporating this new information (as we do here) provides a slightly changed forecast for future unemployment levels.

Regarding interest rates, we forecast that long-term interest rates will remain just about at the levels they were when we made the forecast last month. Short-term interest rates (e.g., the 3-month Treasury bill rate) are forecast to increase somewhat over the 5-year budget window as the economy strengthens and moves closer to capacity. Last week's announcement by the Federal Reserve that short term interest rates will increase slightly is consistent with our forecast, which calls for a 3-month Treasury bill rate averaging 3.4 percent in 1994.

As a measure of the effect of OBRA 1993, consider the projected size of the Federal deficit compared to Gross Domestic Product (GDP) for the next several years. (See Appendix.) In fiscal year 1992, the Federal deficit was 4.9 percent of GDP, in fiscal 1993, it was 4.0 percent of GDP, in 1995 it is projected to drop to 2.5 percent of GDP, and, by 1996 is projected to fall still further to 2.3 percent of GDP, the lowest level since 1979.

Another way to measure the fiscal effect of OBRA 1993 is to examine the trend of public debt to GDP. (See Appendix.) In 1981, Federal debt held by the public equalled 26.5 percent of GDP. Over the next dozen years, this figure increased dramatically, nearly doubling to 51.6 percent in 1993. As a result of OBRA 1993, this trend will be first stabilized and then reversed. The relative level of Federal debt held by the public will begin to decrease over the next several years.

No one can accuse this Administration of incorporating rosy scenarios into its forecasts. In fact, for 4 out of the 5 years in the budget period, the Administration forecasts a higher deficit than CBO (though the differences are quite small). We believe it is critical for policymakers to craft economic policy based on credible data and not to be misled by (or to mislead with) smoke and mirrors. The Clinton Administration prides itself in using credible economic forecasts to craft its economic policies.

The Economic Agenda

The 1995 Budget was quite difficult to construct, as the discretionary spending caps began to constrain the activities of the various agencies. For the first time in memory, agency heads came to realize that increasing spending in any program meant that cuts in other programs had to be made. This was not a pleasant experience for the participants, and it will only get more difficult in future years. However, it is necessary to reorient Federal spending priorities. And this Budget does just that, by providing for several new and expanded investment initiatives, while scaling back or eliminating entirely programs that are less valuable.

Federal employment will be reduced under our 1995 Budget. President Clinton has issued an executive order calling for a reduction of 100,000 full-time equivalent employees. Our Budget exceeds that goal. Further reductions will be necessary to keep future Federal spending within the discretionary spending caps and to meet the personnel reductions recommended in the Vice President's National Performance Review.

However, while discretionary spending is held fixed in nominal terms and Federal employment is reduced, our Budget proposal calls for increases in much-needed public investments. These investments will complement the increased levels of private sector investment we are seeing as a result of lower long-term interest rates. They are intended to increase productivity in both the private and public sector and to help provide a strong foundation for future economic growth. Investment initiatives fall into three main categories:

(1) Physical capital—including full funding for the core highways program under ISTEA, additional resources for Clean Water State revolving funds, and additional funds for high performance computing and the information highways.
(2) Human capital—including increased funding for Head Start, the National Service Initiative, the innovative school-to-work program jointly sponsored by the departments of Education and Labor, and the Workforce Security Initiative sponsored by the Department of Labor.
(3) Technological advances—including increased funding for the National Science Foundation to support research, expansion of the manufacturing extension programs, and reorienting the research priorities of the national defense and energy laboratories toward collaborative work with industry.

This year's Budget contains a number of these investment initiatives. All are intended to provide a new direction for Federal programs, one of helping the private sector provide the kind of economic growth that will improve the living standards of all Americans. Future Budgets will continue this trend.

In the State of the Union address, the President stated that he will propose a welfare reform program this Spring. Since this plan is still under development, I am unable to discuss specifics. However, the Spring package will be the third part of a comprehensive approach to end welfare as we know it. The first step was the substantial increase in the earned income tax credit (EITC) contained in OBRA 1993. When fully phased in (by 1996), the EITC increases will help meet the goal that families with children and a full-time worker shall no longer live in poverty. The second step toward welfare reform is the Health Security Act, which will eliminate the current perverse situation where a person receiving welfare could lose their Medicaid health care coverage by accepting a private sector job. Both these steps attempt to reach the simple goal of making work pay. The third step will be contained in the Spring proposal. By enacting all three steps, Americans will have helped transform welfare into a program that moves people into private sector jobs where they can provide for themselves and their families.

Conclusion

In conclusion, let me reiterate the main points of my testimony. Our economic forecasts make clear that we believe the economy has entered a sustainable expansion phase, accompanied by low inflation and significant job growth.

The 1995 fiscal budget is one more step on the road toward fiscal responsibility. It makes progress toward reorienting government spending priorities in favor of investment and away from current consumption. This is a prudent strategy for us and for future generations.

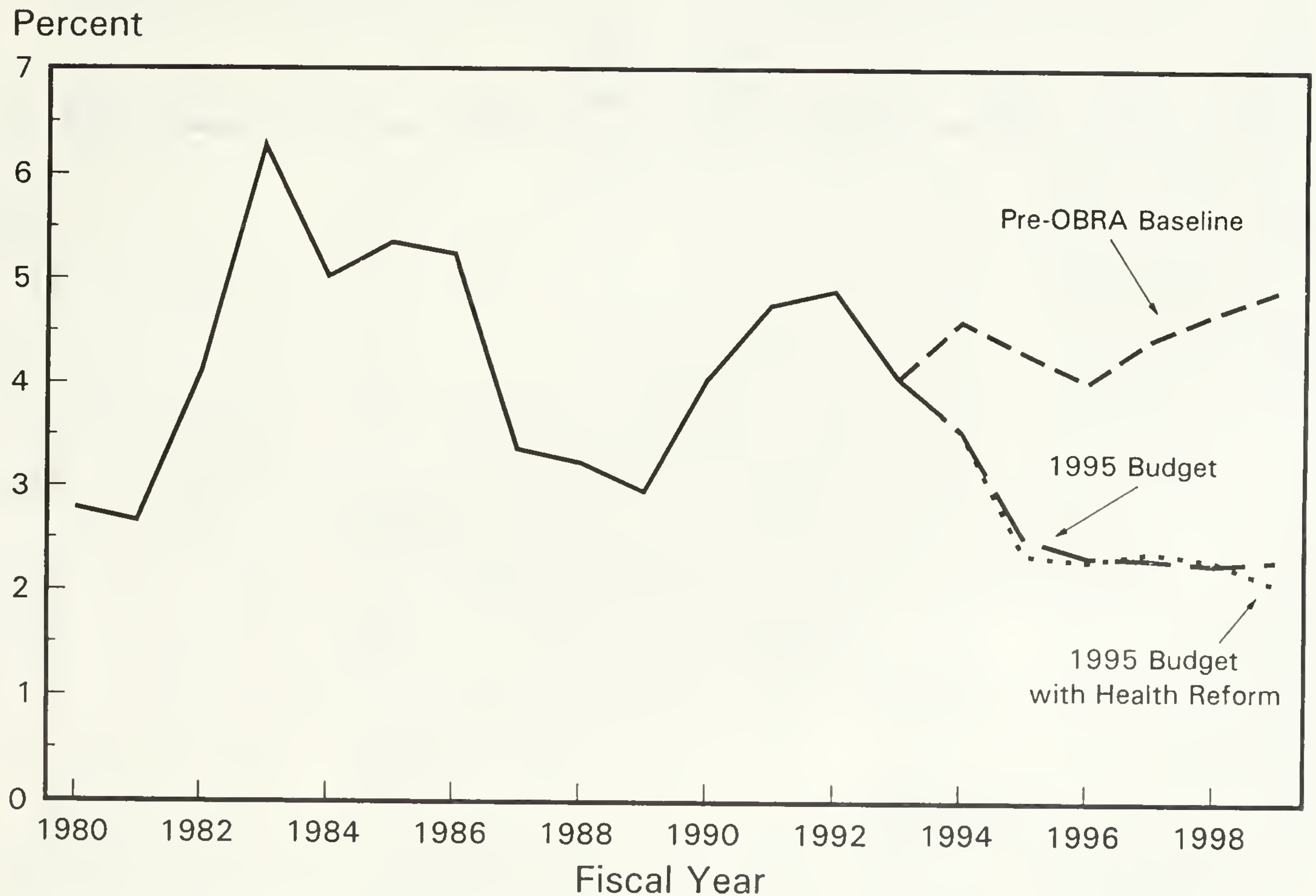
This concludes my testimony. I would like to thank the committee for inviting me here today. I would be happy to respond to any questions that you may have.

TABLE 1

Administration and CBO Economic Assumptions

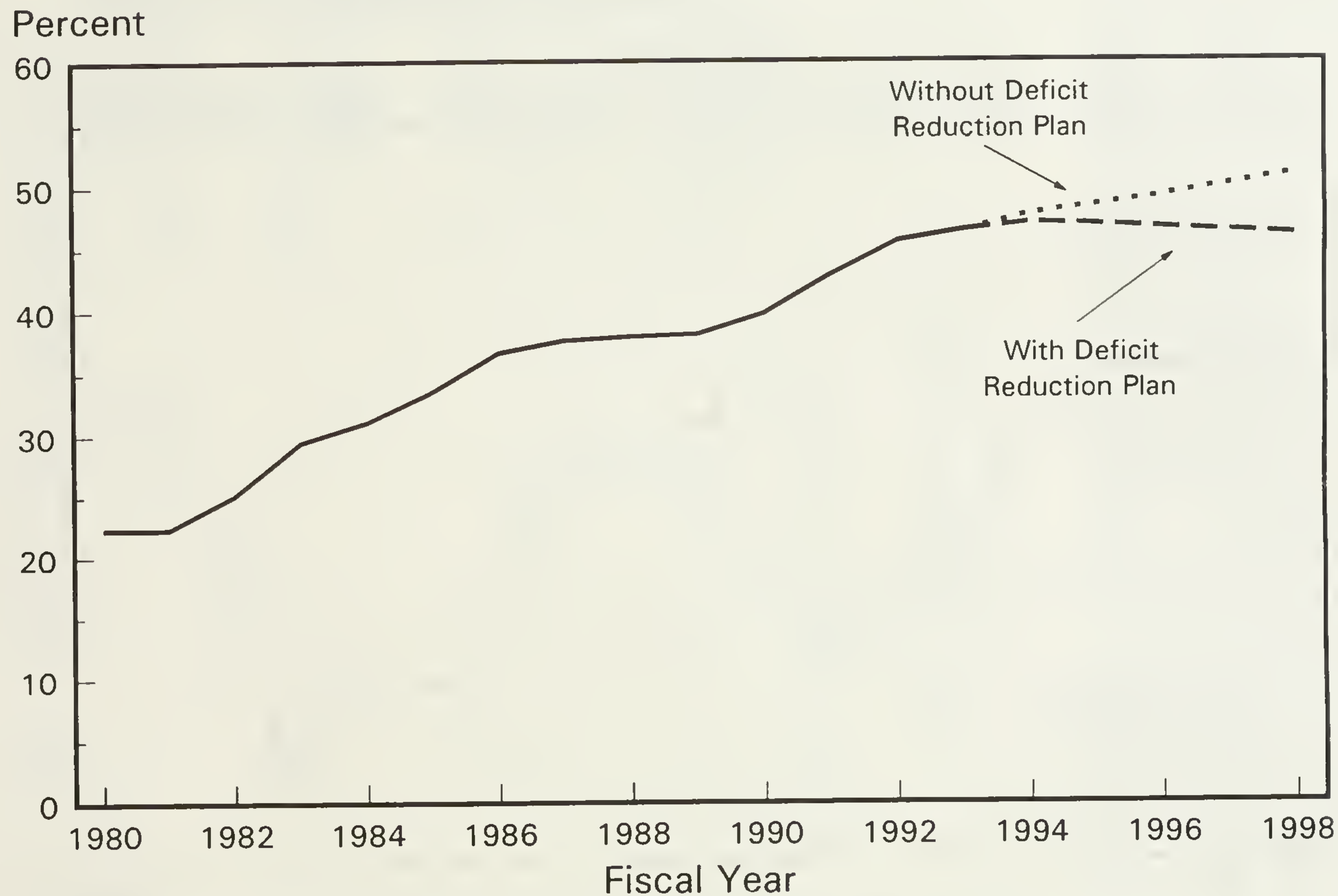
	Calendar Year						
	1993	1994	1995	1996	1997	1998	1999
Real GDP, 4Q/4Q growth (%)	2.8						
CBO assumptions................		2.8	2.7	2.7	2.7	2.6	2.4
Administration forecast........		3.0	2.7	2.7	2.6	2.6	2.5
GDP Deflator, 4Q/4Q growth (%)	2.2						
CBO assumptions................		2.8	2.6	2.6	2.5	2.5	2.4
Administration forecast........		2.7	2.8	2.9	3.0	3.0	3.0
CPI-U, 4Q/4Q growth (%)	2.7						
CBO assumptions................		2.8	3.0	3.0	3.0	3.0	3.0
Administration forecast........		3.0	3.2	3.3	3.4	3.4	3.4
Civilian Unemployment Rate (%) [Old basis, except where noted]	6.8						
CBO assumptions................		6.3	6.1	5.9	5.8	5.7	5.7
1995 Budget forecast...........		6.5	6.1	5.9	5.7	5.5	5.5
Administration forecast........		6.3	5.9	5.7	5.6	5.5	5.5
New basis.................		6.6-7.2	6.2-6.8	6.0-6.6	5.9-6.5	5.8-6.4	5.8-6.4
Three-month T-bill	3.00						
CBO assumptions................		3.50	4.30	4.60	4.60	4.70	4.70
Administration forecast........		3.40	3.80	4.10	4.40	4.40	4.40
Ten-year T-note	5.88						
CBO assumptions................		5.80	6.00	6.10	6.20	6.20	6.20
1995 Budget forecast...........		5.80	5.80	5.80	5.80	5.80	5.80
Administration forecast........		5.70	5.70	5.70	5.70	5.70	5.70

Federal Deficit as Percent of GDP



Note: Data for fiscal 1994-1999 are projections.

Net Federal Debt as Percent of GDP



Note: Excludes effects of health care reform. Net Federal debt excludes debt held by the Federal Reserve. Data for fiscal 1994-1998 are projections.

Chairman SABO. The entire statement will be in the record.

I am sorry, I have to leave shortly, so I will have one quick question, and then I will turn the Chair over to Mr. Beilenson.

When the Federal Reserve made their increase in the Federal funding rate recently, their rationale was that the increase in short-term interest rate was to inhibit inflation and not to interfere with fundamental long-term economic growth. I am just curious about this in relationship to long-term rates, because we are always told that the long-term rates are supposed to relate to the fear of inflation.

And it would seem that, theoretically at least, if the short-term rate is going up to make sure there is not inflation, it should reduce rather than increase long-term rates. On the other hand, 30-year Treasury bonds have gone up 14 basis points in the last week in response to that action by the Federal Reserve.

Did the Federal Reserve miscalculate its impact on long-term interest rates, or do you expect the market to reverse and end up with more stable or even reduced long-term rates?

Dr. TYSON. I think the evidence, if you look at the relationship between short-term and long-term rates right now, even with the adjustment on the short-term rate side, we believe that there is still scope for long-term rates to remain unaffected by a short-term rate increase, because if you think about long-term rates, if we think about where they are and where, say, our inflation forecast is between 1994 and 1996 or 1997, 1998, and other private-sector forecasts of what inflation is likely to be in that period of time, there doesn't seem to be, given the levels of long-term rates that existed last week and any set of inflationary expectations that is comparable to the kind of inflation that everyone seems to be forecasting, there is no reason to predict that long-term rates in fact will stay higher.

So that suggests that we might be seeing a temporary response, perhaps created by some market uncertainty as a result of the move by the Federal Reserve. But there really isn't any economic reason to anticipate that there would be a permanent adjustment upward in long-term rates as a result of the upward adjustment in short-term rates. Or another way to say that is, it is perfectly consistent to imagine that once the market has settled down, short-term rates are higher and long-term rates return to where they were before the short-term rate increase occurred.

Chairman SABO. We live by what the evening news says at times. On Friday night, one network reported the Federal Reserve's action as one of two unsettling events in the economy that day, one being the Federal Reserve's action, the other a misunderstanding of the change in the unemployment rate statistics that caused them to report a significant increase in the unemployment rate. One should maybe have some economic advisers with the producers of the evening newscasts.

Dr. TYSON. Although I think the evening newscast was correct to point out that in fact since the move by the Federal Reserve was—you could argue from many participants in the market, an unexpected event, and since there was indeed a substantial amount of noise in the employment report last Friday because of the change to the new numbers and the weather-related effects on employment generation in the reporting month, there was a lot of noise in what the signals coming to financial participants were, and that can indeed have some temporary, unsettling effect on long-term rates.

That is why I was saying, it is perfectly consistent to view, if you look at economic fundamentals, it is perfectly consistent to anticipate they may indeed come down again.

Chairman SABO. Thank you.

I am sorry I have to leave, but I will turn the Chair over to Mr. Beilenson.

Mr. BEILENSON [presiding]. Further questions of Dr. Tyson?

The gentleman from New York, Mr. Lazio?

Mr. LAZIO. Thank you, Mr. Chairman.

I just want to ask one question, if I can, having to do with the RTC funding, which I supported. I haven't seen the breakout of the consequences of the approval of RTC funding and what that means particularly for low interest rates, which I think drastically decreased the cost of borrowing that was necessary for RTC.

Could you address that point in terms of what the deficit is projected to be in 1995, and what role those lower interest rates and RTC approval had to do with that?

Dr. TYSON. I am afraid I don't have a breakdown specifically for RTC. What I do have is, in the budget discussion here that we had yesterday with Secretary Panetta and in the budgetary document itself, it does point out that if you think about fiscal year 1995, we essentially are seeing—we thought we were going to see a deficit of $302 billion. In fact, we now anticipate a deficit of $176 billion. That is a $126 billion drop.

This is due primarily to two factors. The first factor is the specific cuts and increases in revenues that were enacted last fiscal year—in OBRA 1993. That accounts for $83 billion of the $126 billion improvement. So $83 billion comes from spending cuts and revenue increases.

Twenty-two billion dollars comes from the improved economic outlook, which means the economy is growing better, interest rates are lower. The improved interest rate situation indeed has the effect that you suggested, of both slowing down the number of properties the RTC has had to take in and improving the ability of the RTC to move properties out at a better value more quickly.

But I don't have a breakdown of what part of that $22 billion is simply an RTC phenomenon. I can get it for you, but right now I can tell you it is about $22 billion that is due to the improved economy, of which the RTC effect is—and the RTC effect in turn is due to the improved interest rates.

Mr. LAZIO. Thank you.

Just one other unrelated question. You had made mention of the fact that you believed that in anticipation of the President's program being implemented, interest rates began to drop. There are a number of economists, I think, who would suggest that because of the size of the global economy and floating interest rates and exchange rates, that we don't nearly have as much influence over interest rates as we might have had 20 years ago or perhaps further back than that.

Would you care to be more specific in classifying what role the proposal might have had in the lower interest rates relative to that conceptual framework of the global economy?

Dr. TYSON. I guess I would say that—the way I characterize it in my statement and also in my testimony is we believe the deficit reduction plan, the anticipation of its being passed and then its actual passage, were major factors behind the interest rate decline which occurred between November of 1992 and December, the end of December of 1993. Obviously they are not the only factor. But we believe they are a main factor.

Now, how do you demonstrate that? It is very hard to demonstrate. One thing we have done, and we did this in a little more detail in the Economic Report of the President which is coming out next week, is we first looked at just the timing of the rate declines. The rate itself moved significantly and perceptively, for example, after Secretary Bentsen gave a speech last January talking about the deficit reduction program we were putting together. It moved again downward perceptively when the House passed the program.

It moved up when the Senate looked like it might not pass the program. And it moved down and stayed down dramatically after the Senate finally—after the bill finally passed in August. It seems fairly clear that even though the global capital market is indeed global, that the U.S. is a big enough part of it, and the Federal borrowing needs of the U.S. Government and the anticipated Federal borrowing needs of the U.S. Government are big enough to have an effect on what happens to these interest rates.

And so the effects show up rather clearly in the time trajectory of the interest rate decline. Other than that, all I can do is point to things like the statement by Alan Greenspan and others that I think there is a view that although there are other factors that maybe contributed during this period of time, it was the anticipation and then the passage of the package that was a major contribution.

Again, the conclusion one draws from that is the U.S. is a big part of the global economy, and the Federal Government's borrowing needs anticipated by the financial markets in the future are a big enough drain on global savings that the effect shows up.

Mr. LAZIO. Wouldn't the dampening economies in Japan and Europe, decreasing demand over there, have paralleled some of the remarks made by the Secretary? It seems to me—I don't have it specifically in front of me, but——

Dr. TYSON. The way these markets move, they move on certain dates. That is why—it is not the case that we got economic indicators about Japan and Germany on the day that Secretary Bentsen made his speech or on the day that the House passed the package or on the day that the Senate passed the package.

I think you could say that the fact that Europe and Japan were in recessionary periods dampened demand for global capital, and that exercised a dampening effect on global interest rates. But again, it is kind of an event analysis, when does the rate move down sharply and perceptively in 1993? The answer is, it moves down on those days or moves up in the case—the other interesting one was, it moved up in the anticipation that the plan might not work, or might not hold. That suggests that the major driver during those periods of time was the fate of the fiscal plan—the efforts to control the budget deficit in the United States. That was a major factor.

Mr. LAZIO. Thank you, Mr. Chairman.

Mr. BEILENSON. The gentleman from California, Mr. Berman?

Mr. BERMAN. Thank you, Mr. Chairman.

In 1990, we passed a budget package that cut spending somewhat and raised taxes somewhat. There are people in the other party, even though it was led by a Republican President, who want to say that that was what precipitated the slowdown in the growth, the negative growth and the recession.

How do you account for a similar type of package last summer leading towards the strong fourth quarter, the continued drop in interest rates, the signs of an economy that is getting stronger? Why is this different than then?

Dr. TYSON. I have to say I think a major factor here is what I mentioned at the very outset, which is credibility. The market simply discounted that 1990 effort. It is not to say there wasn't a real effort to control spending. And indeed the discretionary caps began in that period and I think they are an important part of deficit reduction.

But if you looked at the underlying economic assumptions, and if you looked at what the administration said this program would achieve, the market simply didn't believe it. What was supposed to happen to interest rates and supposed to happen to growth, supposed to happen to unemployment and supposed to happen to inflation, given what was actually happening, was not credible.

And I think that was a very significant difference. I think that we have in place here a set—let me just go through again what I think makes this a very credible package.

There were a number of very tough things done here. Credibility is not just about the magnitude of deficit reduction. It is about how serious an administration is and a Congress is to commit to deficit reduction.

And one of the things this package had—and we can go back and retell the history of last year—is some very, very tough choices about increasing tax rates for the upper end of the income distribution. And if you remember in discussions last year, this was going to undermine the economic recovery. This was part of what made our deficit reduction effort credible. It is taking on tough choices and making them stick for a long period of time.

So I think the 1993 plan was really quite different. And it was its credibility that led it to be successful.

Mr. BERMAN. Just one last question, on that point. There are some people who want to say: That is well and good now, and it looks good, but come April 15 when all those people who are expecting a refund find out that they owe money or are expecting to owe a certain amount and find out they owe more—when that hits, that is going to be when the economy starts spinning downwards. What is your reaction to that?

Dr. TYSON. First of all, I think the people who are likely to be hit on April 15—since we know that it is only the top 1.2 percent of the taxpayers in the country who are going to face higher bills on April 15, these are precisely the people who know how to manage their accounts in such a way that it may have a very small effect on what they spend.

Many of these people actually shifted income into 1992 in anticipation of higher taxes in 1993. Many of these people have substantial amounts of savings out of which to pay the higher tax bill and to continue to consume at exactly the rate they were consuming before.

Just yesterday I got a report from Data Resources Institute, a private forecasting firm. They said that maybe the tax increase on April 15 might cut $2 billion of consumption spending. That is compared to a total of $70 billion.

Now, what I want to emphasize here is that tax increases by themselves, just like spending cuts, do exercise some slowdown influence on the economy, if they are taken by themselves.

What has happened in this economy is that the deficit reduction package, which consisted of both spending cuts and tax increases, has allowed a strengthening of interest-sensitive spending which will more than offset any slowdown coming from the tax increase side.

So the economy, by everyone's estimate—not just ours, by everyone's estimate—will grow smartly through that period of time. You will not see that effect in the growth rate.

Mr. BERMAN. Thank you, Mr. Chairman.

Mr. BEILENSON. Thank you, Mr. Berman.

Apparently, Dr. Tyson, you all down there have done just a good job for the economy that we don't have any more questions for you at this point. So if I may suggest with respect that you take the rest of the afternoon off. We thank you very much for coming up here and sharing your testimony with us.

Dr. TYSON. Thank you for your questions.

Mr. BEILENSON. The meeting is adjourned.

[Whereupon, at 2:50 p.m., the committee was adjourned.]

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